Office of Chief Counsel
Internal Revenue Service

memorandum

CC: [redacted]:TL-N-3890-00
[redacted]

date: AUG 16 2000

to: Chief, Examination Division, [redacted]
Attention: [redacted], Team Coordinator
[redacted], Revenue Agent

from: Associate District Counsel, [redacted]

---

subject: [redacted]
Alaskan Settlement
U.I.L. Number 172.01-05

This responds to your request for advice regarding [redacted]'s ("[redacted]") claim seeking 10-year loss carryback treatment under section 172(b)(1)(C) of the Internal Revenue Code[1]. Our advice is provided without prior coordination with the Office of Chief Counsel, pursuant to the 10-Day Post Review procedures of CCDM (35)3(19)4(4), as this issue involves primarily well-settled principles of law. We are required, however, to forward a copy of this memorandum to both the Assistant Chief Counsel (Field Service) and the Northeast Regional Office for review. Within 10 days after receipt, the Associate Chief Counsel is to advise this office as to whether it: 1) concurs with our opinion; 2) believes some modification is appropriate; or 3) needs additional information or time to evaluate our opinion. We will inform you of their response as soon as it is received.

Disclosure Statement

This document may contain confidential information subject to the attorney-client and deliberative process privileges, and may also have been prepared in anticipation of litigation. This document should not be disclosed to anyone outside the Internal Revenue Service ("Service"), including taxpayer(s) involved, and its use within the Service should be limited to those with a need to review the document in relation to the subject matter or case discussed herein. This document is also tax information of the instant taxpayer which is subject to section 6103.

---

[1] All section references hereinafter, unless otherwise indicated, are to the Internal Revenue Code as in effect during the years in issue.

Issue

Whether [redacted] is entitled to 10-year loss carryback treatment under section 172(b)(1)(C) with respect to its [redacted] consolidated net operating loss.

Conclusion

[redacted] contends that state tax and interest expenses which accrued in [redacted] as a result of the Alaskan state tax settlement are to be considered in computing its specified liability losses under section 172(f)(1)(B), as in effect for taxable year [redacted]. However, [redacted]'s position is directly contrary to the Service's position as stated in currently pending litigation. See, Intermet Corp. & Subsidiaries v. Commissioner, 111 T.C. 294, rev'd, remanded, 209 F.3d 901 (6th Cir. 2000). It is the Service's position that otherwise allowable deductions resulting from state tax deficiency and interest do not qualify as specified liability losses because they are not liabilities arising under state law for purposes of section 172(f)(1)(B). As such, [redacted]'s [redacted] refund claim must be denied.

Law

Section 172(b)(1)(C) provides that a "specified liability loss" may be carried back to each of the 10 taxable years preceding the loss year [2]. For taxable year [redacted], the term "specified liability loss" was defined by section 172(f)(1) as:

> ... the sum of the following amounts to the extent taken into account in computing the net operating loss for the taxable year:
>
> (A) Any amount allowable as a deduction under section 162 or 165 which is attributable to -
>
> (i) product liability, or
>
> (ii) expenses incurred in the investigation or

---

[2] Under the general rule of section 172(b)(1)(A) as in effect for taxable year [redacted], a taxpayer could carryback an NOL 3 taxable years before the loss year and forward 15 taxable years after the loss year. Section 1082 of the Taxpayer Relief Act of 1997 amended section 172(b)(1)(A) to shorten the NOL carryback period from 3 years to 2 years and lengthen the NOL carry forward period from fifteen years to twenty years, effective for NOLs for tax years beginning after August 5, 1997.

(ii) expenses incurred in the investigation or settlement of, or opposition to, claims against the taxpayer on account of product liability.

(B) Any amount (not described in subparagraph (A)) allowable as a deduction under this chapter with respect to a liability which arises under a Federal or State law or out of any tort of the taxpayer if -

(i) in the case of a liability arising out of a Federal or State law, the act (or failure to act) giving rise to such liability occurs at least 3 years before the beginning of the taxable year, or

(ii) in the case of a liability arising out of a tort, such liability arises out of a series of actions (or failures to act) over an extended period of time a substantial portion of which occurs at least 3 years before the beginning of the taxable year.

A special 10-year carryback rule for product liability losses was first added to the Code by the Revenue Act of 1978, P.L. No. 95-600, effective for tax years beginning after September 30, 1979. A similar provision for "deferred statutory or tort liability" losses was added by the Tax Reform Act of 1984, P.L. No. 98-369, effective for taxable years beginning after 1983. Section 11811(b) of the Revenue Reconciliation Act of 1990, P.L. No. 101-508, combined pre-1990 RRA section 172(j) (relating to product liability losses) with pre-RRA '90 section 172(k) (relating to deferred statutory or tort liability losses) into section 172(f), and termed which provided rules relating to specified liability losses.

Section 172(f)(1)(B) was amended by section 3004(a) of the Tax and Trade Relief Extension Act of 1998 to provide that a "specified liability loss" includes:

(i) Any amount allowable as a deduction under this chapter (other than section 468(a)(1) or 468A(a)) which is in satisfaction of a liability under a Federal or State law requiring-

(I) the reclamation of land,

(II) the decommissioning of a nuclear power plant (or any unit thereof),

(III) the dismantlement of a drilling platform,

(IV) the remediation of environmental contamination, or

(V) a payment under any workers compensation act (within the meaning of section 461(h)(2)(C)(i)).

(ii) A liability shall be taken into account under this subparagraph only if--

(I) the act (or failure to act) giving rise to such liability occurs at least 3 years before the beginning of the taxable year, and

(II) the taxpayer used an accrual method of accounting throughout the period or periods during which such act (or failure to act) occurred.

Facts

In [redacted], [redacted] and the state of Alaska executed a Closing Agreement settling various tax disputes involving subsidiaries of [redacted][3] and [redacted][4] and their predecessors/successors in interest operating in Alaska. A copy of the Closing Agreement is included herewith as Attachment A. The Closing Agreement provided that [redacted] would pay the state of Alaska a total of $[redacted] over [redacted] years, settling the parties' disputes as to [redacted]'s liabilities under the Alaskan Oil and Gas Production Tax (AS 43.55) for tax years [redacted] through [redacted] and the Alaskan Oil and Gas Corporate Income Tax (AS 43.21) for tax years [redacted] through [redacted].

---

[3] The [redacted] subsidiaries specifically identified in the Closing Agreement include [redacted] ("[redacted]"), [redacted], and [redacted].

[4] [redacted]'s predecessor acquired full control of the [redacted] in the mid-[redacted]'s. It is our understanding that the subsidiaries of [redacted]'s Alaskan operation's were subsequently merged or otherwise became part of the [redacted] consolidated group. It appears that the settlement resolved disputed tax liabilities of a business, i.e., [redacted], which was a [redacted] subsidiary, and not a member of the [redacted] affiliated group during [redacted], the carryback year.

The Closing Agreement states that "...tax, penalty and interest assessments ... are being settled...". [5] (Emphasis supplied.) It does not provide any detail as to the amount of taxes originally in dispute or the basis of such disputes. However, it does allocate the $[redacted] settlement between tax and interest, by subsidiary, tax year, and tax type. The allocation is provided in Appendix A of the Closing Agreement. Notably, the Closing Agreement states: "The Department concurs that this allocation is one reasonable method of allocation given the particular facts and circumstances of this taxpayer."[6] The term "Department" is defined to include only the Alaska Department of Revenue, it does not include any of the other parties to the Closing Agreement, i.e., the Alaska Department of Law and [redacted].

The Closing Agreement provides that the $[redacted] settlement was to be paid in 3 installments. The first installment was due on [redacted], in the amount of $[redacted]. The second and third installments were to be paid on [redacted], and [redacted], both of which were to be equal payments of $[redacted] each.

[redacted] timely paid the $[redacted] over the 3 year period as required under the Closing Agreement and claimed tax and related interest deductions totaling $[redacted] for these years. These deductions were allocated in [redacted]'s consolidated returns between [redacted] and [redacted] as follows:

Year	Actual Payment	Interest Deduction Claimed		Tax Deduction Claimed		Total Deductions
[redacted]	$[redacted]	$[redacted]	$[redacted]*	$[redacted]	[redacted]	$[redacted]
Total	$[redacted]					$[redacted]

* It should be noted that although [redacted] claimed a $[redacted] deduction for tax deficiency interest due the state of Alaska, it did not in fact claim a deduction for any Alaskan tax connected to such interest.

[redacted] reported a consolidated net operating loss ("CNOL") of $[redacted] on its [redacted] consolidated tax return. [redacted] reported a separate loss of $[redacted] and [redacted] reported separate taxable income of $[redacted]. Other members of the [redacted] consolidated group also reported separate losses, e.g., [redacted] - $[redacted]; [redacted] - $[redacted]; [redacted]

---

[5] See paragraph 1.(b) of the Closing Agreement. A reference to the settlement of penalties is also contained in paragraph 2 of the Closing Agreement.

[6] See paragraph 3.(a) of the Closing Agreement.

[redacted] - $[redacted]; [redacted] -$[redacted]. Various other subsidiaries reported separate taxable income.

[redacted] filed a Form 1139 - Corporation Application for Tentative Refund dated [redacted], for taxable year [redacted], carrying back the full amount of the [redacted] CNOL as a deduction against its [redacted] income, and claimed a [redacted] tax refund of $[redacted] (not including interest). [redacted] alleged the full amount of the [redacted] CNOL was eligible for 10-year carryback treatment under section 172(b)(1)(C) as a result of the deductions claimed in [redacted] in connection with the settlement with the state of Alaska, which [redacted] claims satisfied the definition of a specified liability loss under section 172(f)(1)(B)(i), as then in effect. It is our understanding that [redacted] is not claiming that any portion of the separate losses of the other members of the [redacted] group are specified liability losses under section 172(f).

Analysis

It is the Service's position that state tax and interest deductions do not qualify as specified liability losses under section 172(f)(1)(B)(i), because they do not come within the "narrow class of liabilities" to which that subsection applies. Intermet v. Commissioner, 111 T.C. at 300; TAM 199944004. Previously, the Service ruled in PLR 9105022 that an assessment of a state tax deficiency would qualify for 10-year carry back treatment[7]. Similarly, the Service ruled in PLR 9441020, among other things, that assessments of state tax and related interest attributable to tax years at least 3 years prior to the loss year

---

[7] PLR 9105022 involved additional state tax liabilities for taxable year 1989, and hence applied section 172 as it existed prior to amendment by the Revenue Reconciliation Act of 1990, P.L. 101-508 ("RRA '90"). Prior to amendment by RRA '90, then section 172(b)(1)(j) provided that "deferred statutory or tort liability losses" were entitled to 10-year carryback treatment. The term "deferred statutory or tort liability loss" was defined in then-section 172(k), and included, among other things, the same elements of comprising specified liability loss arising under Federal or State law as set for under section 172(f)(1)(B), after amendment by RRA '90. Section 1181(a) of RRA '90 amended section 172(b) to provide that "specified liability losses" receive 10-year carryback treatment. Section 1181(b) of the RRA '90 struck section 172(k), but included its substance in the definition of a specified liability loss under revised section 172(f). As such, the term "deferred statutory loss" as used in pre-RRA '90 and PLR 9105022 equates to the term specified liability loss, as defined section 172(f) as amended by RRA '90.

qualified as specified liability losses.

In Sealy Corp. v. Commissioner, 107 T. C. 177, aff'd, 171 F.3d 655 (9th Cir. 1999), the Tax Court ruled that the portion of an NOL generated by deductions for the following items did not constitute a specified liability loss because the liability for the expenses did not arise under a federal or state law within the meaning of section 172(f)(1)(B): (1) professional fees incurred to comply with reporting, filing, and disclosure requirements imposed by the Securities and Exchange Act of 1934, (2) professional fees incurred to comply with ERISA reporting requirements, and (3) professional fees incurred in connection with an IRS income tax audit.

The Tax Court's decision was based in part upon the legislative history of section 172(f)(1)(B). The court determined that Congress intended the provision to apply only the deduction of liabilities which were deferred due to the economic performance requirement of section 461(h). The Tax Court held that because the economic performance requirement did not delay the accrual of the deductions at issue therein, and the NOLs generated by those deductions could not qualify for specified liability loss treatment.

The Tax Court also applied the doctrine of ejusdem generis[8] to section 172(f), and found that items at issue in Sealy were routine costs, not like those federal or state liabilities which are specifically identified in section 172(f) as qualifying for specified liability loss treatment, i.e., product liabilities, nuclear decommissioning liabilities, and torts. Based upon this rule of statutory construction, the court concluded that Congress intended section 172(f)(1)(B) to apply only to a relatively narrow class of liabilities, similar to those identified in the statute.

In PLR 199922046 the Service reconsidered its position regarding state tax deficiencies set forth in PLR 9105022, and held that state tax deficiencies could not qualify as specified liability losses under section 172(f) as it applied prior to amendment by TTREA '98, and accordingly revoked PLR 9105022.[9] The

---

[8] The ejusdem generis rule of statutory construction provides that where general words follow an enumeration of person or things, by words of a particular and specific meaning, such general words are not to be construed in their widest extent, but are to be held as applying only to persons or things of the same general kind or class as those specifically mentioned.

[9] PLR 199922046 also noted that the portion of an NOL attributable to a state tax deduction could not qualify as specified liability losses under section 172(f)(1)(B) as amended

Service did so by applying the doctrine of ejusdem generis as the Tax Court did in Sealy, and found that the characteristic "inherent delay" shared by the enumerated liabilities set forth in section 172(f) was lacking in the case of state tax liabilities:

> Inherent in the nature of each type of identified liability is an element of substantial delay between the time the act giving rise to the liability occurs and the time a deduction may be claimed for the liability. For example, because of the economic performance requirement a taxpayer's deduction for nuclear decommissioning costs is inherently delayed by the substantial number of years that will expire between the time a nuclear power plant is commissioned and when it is decommissioned.
>
> In contrast to the types of liabilities arising under federal or state law identified in the statute and the legislative history to the 1984 Act, a state tax liability constitutes a routine cost that does not involve an inherent delay between the time the events giving rise to the liability occur and when the deduction for such liability becomes allowable. There may be delays between the events giving rise to a state tax liability and the time when such liability becomes an allowable deduction. For example, an accrual method taxpayer may report too little state tax liability on its tax return, and then may unsuccessfully contest the assertion of a greater tax liability. In this case the tax deduction will be delayed from the time of the events creating the liability until resolution of the contest. Such a delay, however, is not part of the inherent nature of the liability. A taxpayer need not report less than the proper amount of its state tax liability. Thus, a state tax liability does not constitute an inherent delay liability and therefore does not arise under a state law within the meaning of section 172(f)(1)(B).

PLR 199922046 (Emphasis supplied.)

Not surprisingly, the Service has likewise recently published an opinion holding that, as in the case of the underlying state tax liabilities, the related interest accruing on such liabilities also does not qualify for specified liability loss treatment. See TAM 199944004. As in the case of state tax deficiencies, this position is contrary to the Service's previous ruling on state tax deficiency interest in PLR 9441020.

Finally, it is important to note that the Service has also taken

---

by TTREA '98, as state tax liabilities are not among the enumerated qualifying liabilities set forth therein.

position that state taxes and interest are not specified liability losses in cases pending before the U.S. Tax Court and in U.S. District Court. See, Intermet Corp. & Subsidiaries v. Commissioner, 111 T.C. 294, rev'd, remanded, 209 F.3d 901 (6th Cir. 2000). In Intermet, the issue is before the Tax Court on remand from the Sixth Circuit Court of Appeals (the Tax Court did not reach this issue in its original decision). A decision by the Tax Court on this question will not be given prior to the end of August 2000.

Other Comments

a. Allocation of the [redacted] CNOL between specified liability losses and regular net operating losses

We understand [redacted]'s position to be that the only specified liability losses accrued by the [redacted] consolidated group on the [redacted] return were those arising from the Alaska settlement. If so, then [redacted] has incorrectly attributed the full amount of the [redacted] CNOL to the specified liability losses. Section 172(f)(2) provides a general rule that the amount of the specified liability loss for the any taxable year shall not exceed the amount of the net operating loss for the year. However, section 172(f)(5) further provides that in applying section 172(f)(2), a specified liability loss for any taxable year shall be treated as a separate net operating loss for such taxable year to be taken into account after the remaining portion of the net operating loss for such taxable year. [redacted] contention that the [redacted] CNOL is entirely attributable to the claimed specified liability losses is not supportable. We recommend that the methodology of Treas. Reg. Sec. 1502-79 be applied in allocating the CNOL to the alleged specified liability loss amount. See Norwest Corporation and Subsidiaries v. Commissioner, 111 T.C. 105, 164-171 (1998); FSA 199935009.

b. Interest Accruing after Tax Year 1990 fails to satisfy the 3-year rule of Section 172(f)(1)(B)(i).

To qualify as a specified liability loss, [redacted] must also establish with regard to the liability which it alleges arose under state law, that the "... the act (or failure to act) giving rise to such occur[ed] at least 3 years before the beginning of the taxable year ...". Section 172(f)(1)(B)(i). In TAM 199944004, the Service considered as a separate question, assuming arguendo that a state tax liability qualifies as a specified liability loss, whether the interest thereon which economically accrues for the taxable year it becomes deductible, e.g., [redacted], or for the 3 taxable years preceding such taxable year, e.g., [redacted], [redacted], and [redacted], satisfies the 3 year rule of section 172(f)(1)(B)(i). The Service held that

it did not and therefore provided a separate basis for disallowing the portion of the state interest deduction attributable to interest which did not economically accrue more than 3 years prior to the beginning of the loss year.

The Closing Agreement in this case covers tax years [redacted] through [redacted]. The [redacted] group claimed deductions totaling $[redacted] for interest accruing under the settlement through [redacted], pursuant to this settlement. Under the analysis of TAM 199944004, the portion of such interest deduction which economically accrued during taxable years [redacted] through [redacted] is not deductible because it fails to satisfy the 3 year rule of section 172(f)(1)(B)(i).

c. Penalties

The Closing Agreement provides, among other things, that it settles the parties' dispute as to penalties. Closing Agreement, Par. 1.(b). Section 162(f) provides that no deduction shall be allowed under section 162 (a) for any fine or similar penalty paid to a government for the violation of any law. Treasury Regulation Section 1.162-21(a) provides that no deduction shall be allowed "... for any fine or similar penalty paid to ... a State." The term "fine or similar penalty" includes amounts paid in settlement of the taxpayer's actual or potential liability for a fine or penalty (civil or criminal). Treas Reg. Sec. 1.162-21(b)(1)(iii).

Section 162(f) precludes a deduction for a civil penalty imposed for the purpose of enforcing the law and as punishment for a violation of the law. However, it does not, preclude a deduction for a civil penalty that is imposed to encourage prompt compliance with a requirement of the law, or as a remedial measure to compensate another party for expenses incurred as a result of the violation. Southern Pacific Transportation Company v. Commissioner, 75 T.C. 497, 652 (1980). Although penalties were evidently in dispute between Alaska and [redacted], the Closing Agreement does not expressly allocate any portion of the $[redacted] settlement to penalties. We do not believe however, that the fact that penalties were part of the basis of the parties' original dispute is alone sufficient to deny some portion of the $[redacted] settlement deduction under section 162(f). Rather, we believe that at a minimum, facts would have to be established showing that in the settlement negotiations that the state of Alaska was seeking to exact a penalty from [redacted], and that such penalty was in fact exacted as part of the [redacted] settlement. Grossman & Sons, Inc. v. Commissioner, 48 T.C. 15, 29 (1967). We therefore recommend that you obtain: 1)detailed information identifying the specific penalties in dispute; 2) the amount of such penalties sought by Alaska; 3) the nature of the penalties, i.e., punitive or compensatory; 4) the negotiations by the parties with respect to

such penalties; and 5) whether the $[redacted] settlement amount somehow reflects the penalties sought by Alaska.

As we have previously indicated, under the Closing Agreement, representatives of the state of Alaska are not free to discuss the settlement with the Service in the absence of an IRS summons or permission to do so from [redacted]. If you decide that you need to discuss the settlement with the state of Alaska, we recommend that you first attempt to do so by obtaining the necessary consent of [redacted].

d. Potential for carryback of the CNOL to separate return years of the consolidated group members.

It is also important that you accurately identify the members of the [redacted] affiliated group in [redacted] and the [redacted] consolidated group in [redacted] and [redacted]. See Norwest Corporation and Subsidiaries v. Commissioner, 111 T.C. 105, 164-171 (1998); Amtel v. U. S., 31 Fed. Cl. 598 (1994), aff'd 59 F.3d 181 (1995) FSA 199935009. These rulings point out the need for you to accurately identify the members of the consolidated group in [redacted] and [redacted], and to account for those which may have been part of a separate affiliated group in [redacted].

If you have any questions concerning the foregoing, please contact [redacted] at [redacted].

[redacted]

By: [redacted]
Senior Attorney